

Message Text

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C O N F I D E N T I A L SECTION 01 OF 03 NATO 04808

SECDEF FOR OASD/ISA-WILLIAM GEORGE

E.O. 11652: GDS

TAGS: EFIN, NATO

SUBJECT: ECONADS: EFFECTS OF INFLATION ON ALLIED DEFENSE
EXPENDITURES

REF: (A) STATE 119767 (DTG 242144Z MAY 77), (B) PAPENDORP/
GEORGE TELECON, 26 MAY

SUMMARY: ECONOMIC DIRECTORATE HAS CIRCULATED AS ED/EC/77
/45 (UNITED STATES)THE US REVISION OF ED/EC/77/8 (UNITED
STATES), INCLUDING US OF CALENDAR YEAR DATA. CORRIGENDUM
REFLECTING DACOM'D TABLE 1 UPDATE HAS ALSO BEEN CIRCULATED.
WE HAVE SENT BY DACOM COPY OF GERMAN RESPONSE TO ED/EC/77/
8 (GERMANY), TABULAR PORTION OF UK RESPONSE, AND ALSO ED/
77/62, DIRECTORATE COMPILATION OF RESULTS FROM
METHODOLOGIES DESCRIBED IN ED/EC/77/45 FOR CANADA, ITALY,
NETHERLANDS, AND US. WE QUOTE BELOW NARRATIVE PORTION OF
UK RESPONSE SINCE COPY WE RECEIVED WAS TOO FAINT TO REPRO-
DUCE. AT JUNE 2 ECONADS WE WERE UNSUCCESSFUL IN POSTPON-
ING PROPOSED EXPERTS MEETING UNTIL MID-JULY, BUT ALL INTER-
ESTED MEMBERS AGREED TO SOLICIT CAPITALS' AGREEMENT TO
COMPROMISE DATE OF JUNE 28. ACTION REQUESTED: CONCUR-
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RENCE IN THAT DATE. END SUMMARY.

1. GERMAN AND UK ECONADS HAVE CIRCULATED THEIR EXPERTS'
COMMENTS ON ED/EC/77/8 (GERMANY) AND (UK) RESPECTIVELY,
AND WE HAVE HAD THESE TRANSMITTED VIA DACOM TO OASD/ISA-
GEORGE. NARRATIVE PORTION OF UK RESPONSE WAS TOO LIGHT
TO REPRODUCE, HOWEVER, AND SO WE QUOTE THIS BELOW.

2. AT BOTH MAY 26 AND JUNE 2 ECONADS MEETINGS WE MADE POINTS IN REFTEL (AND TIMING CONSIDERATIONS ADDUCED IN TELECON), SEEKING TO POSTPONE PROPOSED JUNE 23 MEETING UNTIL MID-JULY OR SEPTEMBER. AS NOTED TELECON, GERMAN EXPERTS UNAVAILABLE JULY 14. TAKING ACCOUNT OF US AND CANADIAN PROBLEMS WITH JUNE 30 MEETING (REQUIRING EXPERT TRAVEL OVER NATIONAL HOLIDAY WEEKEND), CHAIRMAN BILLY SUGGESTED HOLDING MEETING EARLIER THAT WEEK, AND ALL INTERESTED REPS AGREED TO RECOMMEND JUNE 28 TO THEIR EXPERTS AS COMPROMISE DATE. IF THAT PROVES UNACCEPTABLE, MOST REPS FELT EXPERTS MEETING MIGHT BEST BE POSTPONED UNTIL NEXT YEAR, GIVEN OTHER COMMITTEE COMMITMENTS.

3. REFTEL CROSSED ED/EC/77 (UNITED STATES), WHICH IS A REISSUE OF US REVISION TO ED/EC/77/8 (UNITED STATES), INCLUDING CALENDAR YEAR DATA. THE CORRECTED TABLE I RECEIVED BY DACOM HAS ALSO BEEN CIRCULATED BY THE DIRECTORATE AS A CORRIGENDUM.

4. BEGIN TEXT OF UK REPLY: THE EFFECT OF PRICE CHANGES ON THE DEFENCE EXPENDITURES OF NATO MEMBER COUNTRIES.

1. AT THE MEETING OF NATIONAL EXPERTS WITH THE NATO ECONOMIC COMMITTEE ON 21 AND 22 OCTOBER 1976 IT WAS AGREED THAT STUDIES WOULD BE UNDERTAKEN TO CALCULATE MEMBERS' DEFENCE EXPENDITURE IN CONSTANT PRICES USING VARIOUS APPROACHES.

2. THESE WERE SUBSEQUENTLY SET OUT IN ED/EC/76/72 OF 30 CONFIDENTIAL

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NOVEMBER 1976, AND ARE SUMMARISED BELOW:-

A. 1ST METHODOLOGY

-PERSONNEL EXPENDITURES DEFLATED BY COST INDEX PER HEAD.
- OTHER EXPENDITURE DEFLATED BY PRICE INDEX FOR MANUFACTURED GOODS.

B. 2ND METHODOLOGY

- PERSONNEL EXPENDITURE DEFLATED BY CONSUMER PRICE INDEX.
-OTHER EXPENDITURE DEFLATED AS IN 1ST METHODOLOGY.

C. 3RD METHODOLOGY

-PERSONNEL EXPENDITURE DEFLATED BY PRICE INDEX OF PERSONNEL COMPONENT OF CENTRAL GOVERNMENT EXPENDITURE.
-OTHER EXPENDITURE DEFLATED BY PRICE INDEX OF NON PERSONNEL

COMPONENT OF CENTRAL GOVERNMENT EXPENDITURE.

D. 4TH METHODOLOGY

-PERSONNEL EXPENDITURE DEFLATED BY SPECIFIC OR COMPOSITE
INDEX FOR DEFENCE PERSONNEL EXPENDITURE.
-OTHER EXPENDITURE DEFLATED BY COMPOSITE DEFLATOR DERIVED
FROM SEPARATE PRICE INDICES APPLIED TO SEPARATE COMPONENTS.

3. THE UK EXPLAINED TO THE ECONOMIC COMMITTEE IN OCTOBER

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THAT THE CONSUMER PRICE INDEX (TO BE USED IN THE 2ND
METHODOLOGY, PERSONNEL EXPENDITURE) WAS IRRELEVANT IN THE
UK CONTEXT BECAUSE, UNLIKE OTHER COUNTRIES, A CURRENT OB-
JECTIVE OF GOVERNMENT POLICY WAS TO FORCE DOWN REAL
WAGES AND THEREFORE BREAK THE LINK BETWEEN THE CONSUMER
PRICE INDEX AND WAGE INFLATION. SIMILARLY, THE COMMITTEE
WAS TOLD THAT THERE WAS A RELATIVE PRICE EFFECT (RPE)
FACTOR WHICH DIFFERENTIATED DEFENCE EXPENDITURE FROM OTHER
GOVERNMENT EXPENDITURE (TO BE USED IN METHODOLOGY 3), AND
EXPENDITURE ON MANUFACTURED GOODS (TO BE USED IN METHODOLO-
GY 2).

4. HOWEVER, AS PROPOSED IN ED/EC/76/72 OF 30 NOVEMBER
1976, THE INTERNATIONAL STAFF PROCEEDED WITH THEIR STUDY
OF METHODOLOGIES 1 AND 2, AND PRODUCED ED/EC/77/8 OF
28 JANUARY 1977 SUMMARISING THEIR RESULTS SO FAR. THEY

WERE PREVENTED FROM COMPLETING THE FIRST TWO METHODOLOGIES BY THE NON-AVAILABILITY OF A PRICE INDEX FOR THE PRODUCTION OF MANUFACTURING INDUSTRIES FOR THE UK. THE CHAIRMAN IN HIS COVERING MINUTE SUGGESTED THAT NATIONAL EXPERTS MIGHT WISH TO PROVIDE THE MISSING DATA.

5. IN VIEW OF THE SHORTCOMINGS IN METHODOLOGIES 1 AND 2 (SEE PARAGRAPH 3 ABOVE) WHICH WOULD SERVE ONLY TO DISTORT ANY ATTEMPT TO CONVERT UK DEFENCE EXPENDITURE TO A
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CONSTANT 1970 PRICE BASE, AND GIVEN ALSO THE LIMITED RESOURCES AVAILABLE TO BE DEVOTED TO THIS WORK, THE UK IS UNABLE TO COMPLETE THE INTERNATIONAL STAFF'S WORK IN THIS AREA.

6. HOWEVER, AS REQUESTED IN THE CHAIRMAN'S PAPER OF 30 NOVEMBER 1976, AND DESPITE UK RESERVATIONS ABOUT METHODOLOGIES 3 AND 4 HAS BEEN CARRIED OUT:

A. FOR METHODOLOGY 3, THE UK WAS ABLE TO OBTAIN INDICES FOR BOTH THE PERSONNEL AND NON-PERSONNEL COMPONENTS OF CENTRAL GOVERNMENT EXPENDITURE. THESE WERE APPLIED TO THE RELEVANT DATA CONTAINED IN TABLE 1 OF ED/EC 77/8 OF 28 JANUARY 1977; THE RESULTS ARE AT ANNEX A, TABLES 1-3.
B. FOR METHODOLOGY 4, A COMPOSITE DEFLATOR BASED ON SEPARATE INDICES FOR EACH COMPONENT OF DEFENCE PERSONNEL EXPENDITURE, AND A COMPOSITE DEFLATOR DEEMED FROM SEPARATE INDICES FOR THE VARIOUS COMPONENTS OF OTHER DEFENCE EXPENDITURE WAS USED. CALCULATION OF A WEIGHTED AVERAGE PROVIDED ONE DEFLATOR FOR TOTAL DEFENCE EXPENDITURE. THE RESULTS ARE SET OUT IN ANNEX B, TABLES 1-4.

7. A COMPARISON OF METHODOLOGIES 3 AND 4 THE EFFECT OF APPLICATION OF THE DEFLATORS PRODUCED BY THESE 2 METHODOLOGIES TO THE OUTTURN FIGURES FOR DEFENCE EXPENDITURE AT CURRENT PRICES OVER THE PERIOD 1968-1975 IS BEST ILLUSTRATED BY THE GRAPH AT ANNEX C. THE SOLID LINE REPRESENTING METHODOLOGY 4 REFLECTS ACCURATELY THE FLUCTUATIONS IN DEFENCE EXPENDITURE AT CONSTANT PRICES THAT HAVE BEEN RECORDED IN SUCCESSIVE UK PUBLIC EXPENDITURE WHITE PAPERS. BUT THIS RESULT WAS NOT UNEXPECTED SINCE THE INDICES USED WERE DERIVED DIRECTLY FROM THE METHOD BY WHICH THE UK MAKES ITS OWN ASSESSMENT OF THE EFFECT OF INFLATION ON THE DEFENCE BUDGET FROM ONE FINANCIAL YEAR TO THE NEXT AS PART OF THE PUBLIC EXPENDITURE SURVEY SYSTEM. IN COMPARISON WITH METHODOLOGY 4, THE BROKEN LINE REPRESENTING METHODOLOGY 3 ILLUSTRATES THE DISTORTIONS THAT
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OCCUR WHEN INDICES RELATING TO ALL CENTRAL GOVERNMENT EXPENDITURE ARE APPLIED TO DEFENCE ALONE. IN SOME YEARS, THE TREND IS THE OPPOSITE OF THE CORRECT ONE SHOWN BY METHODOLOGY 4. IN PARAGRAPH 3 ABOVE IT WAS POINTED OUT THAT IN THE UK A RELATIVE PRICE EFFECT DIFFERENTIATED NOT ONLY BETWEEN EXPENDITURE ON DEFENCE AND EXPENDITURE ON MANUFACTURED GOOD - THUS INVALIDATING METHODOLOGIES 1 AND 2 - BUT ALSO BETWEEN DEFENCE AND OTHER CENTRAL GOVERNMENT EXPENDITURE. IT IS LARGELY THIS, IN CONJUNCTION WITH DIFFERING BILL-PAYING PATTERNS DURING PERIODS OF HIGH INFLATION, THAT IS RESPONSIBLE FOR THE DISTORTIONS CONTAINED IN THE RESULTS PRODUCED BY METHODOLOGY 3.

8. CONCLUSIONS

A. METHODOLOGIES 1 AND 2 HAVE NO RELEVANCE FOR THE UK (SEE PARAGRAPHS 3 AND 4 ABOVE). IT IS RECOGNISED, HOWEVER, THAT THESE METHODS MIGHT PROVIDE THE ONLY MEANS OF CALCULATING THE EFFECT OF PRICE CHANGES ON THE DEFENCE EXPENDITURES OF THOSE NATO COUNTRIES WITH LESS STATISTICAL DATA AVAILABLE FOR CALCULATING INDICES RELATING SPECIFICALLY TO THE VARIOUS ELEMENTS OF DEFENCE EXPENDITURE.

B. METHODOLOGY 3 CONTAINS DISTORTIONS RESULTING FROM THE RELATIVE PRICE EFFECT WHICH DIFFERENTIATES DEFENCE FROM OTHER CENTRAL GOVERNMENT EXPENDITURE. THE DISTORTIONS ARE OF SUCH SIGNIFICANCE THAT THIS METHODOLOGY IS WHOLLY INAPPROPRIATE TO THE UK.

C. METHODOLOGY 4, WHICH EMPLOYS THE INFORMATION USED BY

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THE UK IN CALCULATING THE EFFECTS OF INFLATION FOR ITS OWN
PLANNING PURPOSES, PROVIDES THE ONLY ACCEPTABLE MEANS OF
REDUCING UK DEFENCE EXPENDITURE TO A CONSTANT
1970 PRICE BASE. IT IS RECOGNISED, HOWEVER, THAT NOT ALL
NATO COUNTRIES WILL BE ABLE TO PROVIDE SUCH ACCURATE
DEFLATORS FOR DEFENCE EXPENDITURE, AND THAT OTHER
METHODOLOGIES MAY HAVE TO BE RESORTED TO. IN SUCH CIR-
CUMSTANCES IT WOULD BE UNWISE TO TRY TO DRAW INTERNATIONAL
COMPARISONS BETWEEN DEFENCE EXPENDITURES DEFLATED TO A
CONSTANT 1970 PRICE BASE WHEN THE ACCURACY OF THE METHODS
CAN VARY SO WIDELY. END TEXT.

5. ACTION REQUESTED: COMMENT ON JUNE 28 COMPROMISE
MEETING DATE IN TIME FOR JUNE 9 ECONADS.

6. SINCE FOREGOING PREPARED GERMAN REP (PLUISCH) IN-
FORMED US HE HAS BEEN AUTHORIZED TO AGREE TO JUNE 28
EXPERT MEETING DATE. BENNETT

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